annual Bell Operating Company gross plant additions — the amount of new capital assets acquired during each year — averaged about 10% of each BOC's total plant in service. Over a five-year time frame, an ILEC will on average replace some 50% of its plant, an amount that is grossly in excess of even the most optimistic (or pessimistic, from the standpoint of the ILECs) predictions of competitive inroads. Even if the loss of demand for ILEC services were to occur as the ILECs fear, they would still have ample opportunity to adjust their capital spending to accommodate the new market reality.

- *ILECs have no entitlement to be "made whole" with respect to competitive losses.* Competition cannot reasonably be expected to develop if the incumbent will always be made whole with respect to competitive losses.

- *Competitors are not the "cause" of any "stranded investment," and should in no case be required to reimburse incumbent ILECs for such "losses."* The decision to permit competitive entry and thereby to modify or even abrogate the "regulatory bargain" has been made by the public generally (via regulatory authorities, legislatures, and the courts) *and in many cases with the support of the ILECs themselves* as a *quid pro quo* for certain regulatory and market entry changes that the ILECs affirmatively sought to achieve. Hence, if there is any entitlement on the part of the ILEC to be "made whole" with respect to any "damages" that the ILEC may have suffered or may in the future suffer as a result of this fundamental change in US telecommunications policy (which there is not), it would be the public generally, and not those who elect to enter the market as competitors, who must accept the burden of defraying such losses.

- *The adoption of price cap regulation de-links rates from costs and terminates the "investment recovery and return" aspects of the "regulatory bargain."* Under price caps or other forms of incentive regulation, any linkage between rates and costs is, in principle, permanently severed (at least that is the claim advanced by ILEC proponents of price cap regulation). The "going in" rate level for a price caps regime is driven principally by the embedded cost revenue requirement of the utility extant at the time that price cap regulation was first adopted. Whatever that revenue requirement may be, it implicitly captures and reflects the revenue requirement associated with plant then in service. Since the annual adjustment factor is applied initially to the "going in" embedded revenue requirement and subsequently to previously-adjusted incarnations thereof, the presence or absence of any specific amount of stranded plant does not enter the calculation and thus has no direct effect upon the revenue level of the ILEC.

C. While recovery of forward-looking costs identified as "shared," "joint," or "common" may be appropriate with TSLRIC, the ILECs fail to distinguish between such costs and "historical" or "embedded" costs.

In arguing for full recovery of costs the ILECs intermingle arguments for the necessity of recovery all joint and common costs, with the necessity of recovering all historic or embedded costs, as if the two are the same. In fact, the two kinds of costs, and the ILECs' entitlement to recovery of such costs, are vastly different. For example, in his affidavit prepared for USTA, Prof. Hausman appears not to recognize any distinction among the concepts of "joint," "shared" or "common" costs and "historical" or "embedded" costs, yet it is critically important that such a distinction be made. A "properly defined" TSLRIC may include an appropriate, competitively neutral apportionment of forward-looking shared (joint) costs and the maximum attribution of so-called "common" costs to individual services for inclusion in their respective TSLRIC values. Properly set TSLRIC-based prices should be set at a level that is sufficient to recover forward-looking costs including a reasonable profit, but not designed to recover "historical" or "embedded" costs that have nothing to do with the future provision of service.

D. ILECs mischaracterize TSLRIC as denying them recovery of any joint and common costs.

Hausman constructs a "straw man" TSLRIC methodology in which *all shared costs* are excluded. Hausman *misstates and mischaracterizes* the TSLRIC concept, and then proceeds to debunk his self-devised version. A properly designed TSLRIC methodology allows for the attribution of an appropriate level of forward-looking joint (shared) costs to individual services.[14] "Joint" or "shared" costs incurred on a forward-looking basis are incremental costs of a group of two or more services and should be recovered from those services in a competitively-neutral manner.[15] "Common" costs incurred on a forward-looking basis are often capable of direct attribution at least to a major service group (where they can be treated as shared costs among the individual services within the group) and in many cases assigned exclusively to individual services. Many costs that are denominated by ILECs as "common" are given that designation not so much because of any inherent difficulty in making direct product-specific assignments, but rather because the subject cost may be incurred by the ILEC for reasons having nothing at all to do with *any* existing service. For

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14. See Ad Hoc initial comments at 38-42. See also CFA at 37 - 49, and AT&T at 61 - 65.

15. For example, shared costs could be "assigned" to each of the individual services that such costs benefit in the same proportions as the direct TSLRICs for each of the services. Recovery of shared costs would not satisfy this "competitive neutrality" requirement if, for example, they were assigned disproportionately (or totally) to the noncompetitive services with little or none at all being assigned to the competitive services which together require their presence.

example, product development costs that are associated with services that will be offered perhaps years into the future are not legitimately recoverable from any particular *existing* service, but must instead be seen as investments by the ILEC's *shareholders* in support of future revenues and earnings [16]

As stated in Ad Hoc's initial comments at 40, it is essential that the Commission not lose sight of the importance of *cost causality* in formulating its TSLRIC rules - and this principle is particularly important for the assignment of "shared" costs. Costs that are not incurred for the provision of any existing regulated services should not be recovered from any regulated service; if characterization of such costs as "common" has this effect, that characterization is wrong and must be rejected. Similarly, costs that are incurred to support the ILECs' existing *retail* services and that are not relevant to an unbundled *wholesale* service offering, such as Corporate Advertising Expenses, should also not be treated as common. Proper tracking of costs to the services for which they are incurred is essential if the TSLRIC analysis is to produce economically meaningful forward-looking costs.

E. ILECs overstate the portion of forward-looking costs that would not be recovered by a TSLRIC study.

As discussed above, the TSLRIC approach envisioned by Ad Hoc would include assignment of efficient, forward-looking joint and common costs to TSLRIC-based prices. However, even absent such an assignment, the ratio of "recoverable" direct costs to "unrecoverable" shared/common costs characterized by the ILECs in this proceeding is grossly overstated. The assertions regarding joint and common costs as a percentage of total costs attribute those costs as representing as much as 50% of the costs of the firm (in part this may be a function of the confusion between the notion of "joint/shared/common" costs and "historical/embedded" costs discussed above). NYNEX, for example, contends that if TSLRIC were used for pricing access charges, a 50% reduction in rates would ensue, thus eliminating the net earnings of most RBOCs.[17] NYNEX argues further that if TSLRIC were applied only to interconnection, it would provide no incentive for ILECs to invest in their networks and, furthermore, as ILECs lost retail market share, they would lose

16. Under traditional rate base/rate of return regulation and protected monopoly, it may have been reasonable for such costs to be flowed through to ratepayers at the time they were incurred on the basis that, assuming no change in the regulatory paradigm, ratepayers rather than shareholders would be the ultimate beneficiary of such undertakings. That proposition cannot be supported under "price cap" or other forms of incentive regulation, or where there is a distinct possibility that the new service, once introduced, will fall outside of the ambit of ILEC regulation altogether. USTA and its members are strong advocates of incentive regulation and even deregulation, yet are willing to adhere to archaic notions of "common costs" that, while possibly valid under RORR, cannot be squared with current regulatory practices and policies.

17. USTA's Hausman recognizes that "[f]ixed and common costs are typically estimated at about 50% or more of total LEC costs." Hausman affidavit, para. 10, footnote 1.

their ability to recover common costs that would still be incurred even if the ILECs acted as wholesale carriers.[18]

Sprint provides evidence from a cost study filed by Bell Atlantic on the public record in Maryland (Case 8584, Phase II) that counters the assertions of the ILECs. The data provided by Sprint demonstrates a shared incremental and shared overhead cost level equal to 16.6% of total embedded costs.[19] MCI argues that "[s]hared and common costs are not a high proportion of total economic costs of providing interconnection or network elements. The perception that these costs are high is based on two incorrect assumptions: (1) that loop costs are shared among a variety of services; and (2) that all non-service specific embedded or historical ILEC costs are economic shared or common costs. ... In general, shared costs are minimized when costs are examined on a network function basis. Moreover, costs that cannot be attributed directly to the efficient provision of individual services are not necessarily economic shared costs."[20]

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18. NYNEX at 54.

19. Sprint at 49.

20. MCI at 66

III. TSLRIC is consistent with the "reasonable profit" language articulated in the Act, and no reasonable interpretation of the Act or application of its public policy principles would allow the ILECs to add a second and entirely uneconomic "profit" markup to costs that already include a "reasonable profit."

As all acknowledge, the Act *permits* the price for interconnection and unbundled elements to include a "reasonable profit," although it does not (as some ILECs suggest) *require* that a profit be included. The ILECs contend that no profit is recovered when prices are based upon TSLRIC and is thus inconsistent with the Act's intentions. This is simply not the case. As numerous parties recognize, the economic cost calculation represented by TSLRIC *already includes a reasonable return on capital*, which is "profit" in the economic sense of this term.[21] Indeed, any profit level in excess of such a "reasonable return on capital" would be viewed by economists as *excess* or *monopoly profits*, whose generation is clearly *not* contemplated by the Act. As MCI aptly notes, the fact that Congress rejected the rate of return model as the form of regulation means that it is improper for the ILECs to recover historical costs and a return on embedded costs.[22] Further, a reasonable profit is not the same as and should not be confused with a "contribution" to costs associated with network services having nothing to do with the network elements or interconnection that is the subject of discussion in Section 252 of the Act.[23]

After arguing that every conceivable type of cost (historical, embedded, incremental, and other) be recovered from competitors through interconnection and unbundled element prices, some ILECs have the temerity to stretch the pricing standard even further with respect to the inclusion of a "profit." For example, NYNEX raises an entirely speculative notion that the use of the word "profit" in the statute may reflect a Congressional intent "to include an additional return on equity to recognize the increased risk factor that investors will apply to the ILECs due to increased competition in the local exchange."[24] According to this theory, not only did Congress intend to ensure that ILECs would be able to set rates so as to make them whole from competitive losses, the ILECs would be permitted to earn additional return to compensate them for the risk of *not being made whole*. NYNEX's

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21. See, e.g., MCI at 61-62; LDDS at 61.

22. MCI at 62.

23. *Id.*

24. NYNEX at 42-43, footnote 84; see also, Bell Atlantic, Appendix B, Crandall at 10.

position is nonsensical and inconsistent.[25] Similarly, USTA argues that "a reasonable profit means a positive profit, not just a return on capital."[26]

With this argument, the ILECs attain new levels of overreaching. The ILECs attempt to create a "fuller than full" cost recovery (backward and forward-looking at the same time), and to then, as the icing on the cake, to collect a further level of markup as a sort of bounty for agreeing to participate in the competitive market.

NYNEX goes so far as to suggest that without this final (and extraneous) level of "profit," ILECs may subsidize CLECs' entry.[27] While regulators should establish "pro-competition" rather than "pro-competitor" policies, they should remain extremely skeptical of claims, such as NYNEX's, that ILECs require such "total cost recovery" in order to remain viable.[28] The real concern should be that CLECs (and ultimately the consumers who seek competitive choices) will be forced to subsidize the ILECs' mis-allocation of costs to monopoly rate elements. NYNEX's total cost recovery recommendation is a euphemism for being made whole for all competitive inroads, being able to recover its entire embedded rate base, *and then some*.

The objective of the Act is to set prices based on cost and to do so in a manner that is fair and that promotes competition. The fact that return (or profit) is already reflected in TSLRIC further supports its use as the basis for pricing under the Act. As stated by the Department of Justice, pricing "based on TSLRIC is best suited to ensure effective and efficient entry, efficient production of end services, competitive pricing to end users, and the avoidance of anticompetitive behavior by ILECs to preserve their market power."[29] As the DoJ correctly observes, in a competitive market, prices would be driven down to forward-looking costs, even if such costs were less than a firm's historical costs.[30] As also aptly observed by the Department of Justice, although the Commission should certainly be aware of the practical implications of endorsing TSLRIC, the TSLRIC standard would promote the statutory goal of competition, and "alternative pricing standards entail a

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25. While NYNEX argues that "Congress clearly intended to permit the ILECs to recover, at a minimum, their full costs including the cost of capital," and postulates that while Congress "may have intended an additional profit above the cost of capital," NYNEX magnanimously allows that it would not seek to recover this additional "risk premium." NYNEX at 46-47, footnote 96.

26. USTA at 43, Hausman Aff. at paras. 12-13.

27. NYNEX at 45.

28. NYNEX at 46.

29. Department of Justice at 28.

30. DOJ at 29.

substantially greater risk of impeding, rather than promoting, the emergence of competition."[31]

31. Department of Justice at 33

IV. The goal of facilitating economic entry into local markets needs to be considered in the context of the history of the telecommunications industry.

The Department of Justice rightly points out the ILECs' obdurate behavior during the last 30 years. The dynamics of the relationship between the incumbent carriers and potential new entrants clearly affects the negotiation between the two: This is not a situation with two parties with equal stakes but rather a situation where one party benefits from delay and the other party is harmed by delay. As observed by the Department, the history of telecommunications "over the last thirty years has been marked by long, contentious negotiations in which incumbent dominant providers used a variety of delaying tactics at the negotiating table to impede entry or hobble potential rivals."[32] The Ad Hoc Committee's initial comments in this proceeding provided recent evidence of continued bad faith on the part of the ILECs relative to the implementation of the Commission's Expanded Interconnection requirements.[33] While the ILECs' interest in offering in-region interLATA calls theoretically creates some incentive for them to negotiate expeditiously, it does not create enough of an incentive for them to negotiate on "equal terms" with CLECs. Informed by the history of ILEC behavior, the FCC should establish pricing principles to guide expeditious resolution of contested interconnection matters.

32. Department of Justice at 25-26.

33. Ad Hoc at 17-21.